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IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

ROBERT L. BROWN, *et al.*,
Petitioners,

v.

PERRY MENDEL,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

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RESPONDENT'S BRIEF IN OPPOSITION

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RESPONDENT'S BRIEF IN OPPOSITION

COUNTER-STATEMENT OF THE CASE

Respondent Perry Mendel founded a company in the late 1960's that later became Kinder-Care, Inc. ("KCI"). Mendel served as the company's president until 1985, when he became chairman of its board of directors. Pet. App. at A-2. As the KCI grew, it diversified its business holdings. In 1987, KCI formed Kinder-Care Learning Center, Inc. ("KCLC") as a wholly-owned subsidiary to house its child-care business. Mendel chaired KCLC's board of directors. Pet. App. at A-2.

Soon after KCLC was established, KCI's management began considering plains to spin-off KCLC. In 1988, KCI caused KCLC to conduct a public offering of its stock, reducing KCI's holdings to 87% of KCLC's common stock. On May 29, 1989, KCI announced plans for a corporate restructuring to completely separate KCLC from KCI. Pet. App. at A-2.

Part of this restructuring called for separate boards of directors for KCI and KCLC. To that end, Mendel resigned as chairman of KCI's board effective May 29, 1989, and no longer held any position with KCI. He remained chairman of KCLC's board. In this capacity, Mendel had "very little contact" with KCI's board and retained only a 2.6% stock ownership interest in KCI. Pet. App. at A-2.

KCI's board, and its chairman and long-time president, Richard Grassgreen, continued to plan the spin-off. In September 1989, KCI's board discussed alternative plans to spin-off KCLC. Mendel attended this meeting, but no new plan was adopted. Later, at a subsequent meeting not attended by Mendel, KCI's board adopted a new plan and announced it on September 22, 1989. Under the new plan, KCI shareholders would be issued rights to purchase KCI's shares of KCLC stock. Pet. App. at A-2.

KCI issued a Prospectus to its shareholders on October 4, 1989. The Prospectus was prepared primarily by KCI's attorney; Mendel did *not* participate in its preparation. Pet. App. at A-3. The Prospectus states that "KCI and KCLC were commonly controlled when the terms and conditions of the Restructuring Agreement and the Related Agreements were agreed upon," referring to the fact that *KCI* continued to own 87% of KCLC's common stock and, therefore, controlled KCLC.

Although Mendel did not assist in preparing the Prospectus, he did send a letter, dated October 5, 1989, to *KCLC* (not KCI) shareholders, enclosing the Prospectus and informing them of the upcoming restructuring and

enclosed a copy of the prospectus *for the information* of KCLC shareholders. Pet. App. at A-3.

Petitioners are shareholders of KCI (which pursuant to the restructuring became The Enstar Group, Inc.), who bought KCLC stock from KCI. Petitioners brought a three-count complaint against Enstar, Grassgreen and Respondent Mendel alleging material omissions and fraud in the Prospectus. Enstar and Grassgreen filed for bankruptcy, and Petitioners dismissed them from the action. Pet. App. at A-3.

Only Count I of the complaint is at issue here. Petitioners alleged that Mendel is secondarily liable as a "controlling person" of KCI under Section 20(a) of the Securities Exchange Act of 1934 (the "Act") for KCI's alleged failure to disclose material facts in the Prospectus. This was asserted to be a violation of Section 10(b) of the Act and rule 10b-5 promulgated thereunder by the Securities and Exchange Commission. Pet. App. at A-3.

The district court granted summary judgment, finding "that the evidence viewed in the light most favorable to the plaintiff fails to establish a question of fact as to Mendel's liability as a 'controlling person' of KCI." Pet. App. at B-16. The Court of Appeals for the Eleventh Circuit affirmed, holding that the district court had applied the correct standard and that plaintiffs had failed to present a basis for holding Mendel liable as a controlling person of KCI under any test. Pet. App. at A-1.

REASONS FOR DENYING THE WRIT

As the Court of Appeals held, Respondent Mendel could not be found liable as a "controlling person" under Section 20(a) of the Act under any of the "tests" applied by the courts of appeals as a gloss on the statutory language. To be sure, the Court of Appeals recognized that the circuit courts do not agree "exactly" on the relevant analysis in determining whether someone is a "controlling person" under § 20(a), though they all use an analyti-

cally similar "two prong" approach. But the Court of Appeals in this case employed the variant that was most favorable to Petitioners' position; indeed, it expressly reserved the question whether, in a close case, it would bow to the "test" employed in other circuits. Accordingly, even if there were a substantial conflict in the circuits about the proper two-part test for "controlling person" that might, in some future case, merit the attention of this Court, the facts of this case do not permit the Court to address that conflict here.

Beyond the alleged conflict, Petitioner's arguments (under the heading, the "Decision Below is Erroneous") are entirely fact-bound. They rest largely on mischaracterizations of the record and address no issue that would warrant a writ of certiorari.

I. THIS CASE DOES NOT PRESENT A CIRCUIT CONFLICT

Petitioners argue that there is a conflict in the circuits. But whatever conflict might exist is illusory in the context of this case.

1. Section 20(a) of the Securities Exchange Act of 1934 provides that:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable. . . .

15 U.S.C. § 78t(a). The regulations promulgated under the Act define control as "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person." 17 CFR § 230.405 (1995).

2. In applying § 20(a), the circuit courts have added some gloss to the statutory language. That gloss requires

the plaintiff seeking to impose "controlling person" liability to focus on two issues. There is more than one such test in vogue, but the first prong of each test looks to the general relationship between the defendant and the controlled entity; the second prong looks to that relationship in the context of the specific activity that gave rise to the claim. *See* Pet. App. at A-6 (noting the widely followed *Metge* approach); Pet. App. at A-7 (noting its own formulation); *see also Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir.), *cert. denied, Carpenter v. Edwards & Warren*, 444 U.S. 868 (1979).

3. In this case, the Eleventh Circuit adopted the following formulation: A person is liable as a controlling person if he or she

> (i) "had the power to control the general affairs of the entitity primarily liable at the time the entity violated the securities laws"; and
>
> (ii) "had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability."

Pet. App. at A-7 (quoting *Brown v. Mendel*, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994)).

4. As Petitioners point out, the *second* prong of the test, focusing on "control" in the context of the specific activity in question, has been a matter of some disagreement in the courts. A minority of circuits have employed a "second prong" that requires the active, "culpable" participation of the defendant in the assertedly fraudulent transaction. Thus, some circuits require that the "controlling person" be a "culpable participant" in the fraud. *See, e.g., Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 889-90 (3rd Cir. 1975) ("secondary liability cannot be found under Section 20(a) unless it can be shown that the defendant was a culpable participant in the fraud"). That standard places a substantial burden on a plaintiff seeking to prove defendant to be a "controlling person."

The Eleventh Circuit, however, rejected the "culpable participant" formulation for the second prong, relying on the plain language of the statute to hold that, "Neither [the regulation] nor the statute appears to require participation in the wrongful transaction." *See* Pet. App. at A-7 n.5.

Therefore, whatever need might exist to resolve issues associated with the "culpable participant" formulation, that need cannot be met in this case. *Petitioners concede that this aspect of the case law is not at issue in this case.* Pet. at 10. The Eleventh Circuit has chosen the more lenient standard. Therefore, to the extent the second prong of its test conflicts with the law of other circuits, Petitioners were not prejudiced by it. Pet. at 10.

Moreover, the Court of Appeals had no occasion to reach any issue with respect to the "second prong" because it concluded (as had the district court) that there was no evidence to support a finding that Mendel was a controlling person under the first prong (see *infra*). Indeed, while Petitioners assert that the "tests" need broadly to be considered by this Court, this would be a very poor case in which to try to do so: neither the district court nor the Court of Appeals even discussed the facts of record that relate to the second prong of the test.

5. Petitioners maintain, however, that this case presents an occasion to address a conflict in the first prong. Petitioners are mistaken.

As noted above, the first prong of the test employed in the Eleventh Circuit, based squarely on the statutory language, addresses whether the alleged controlling person "had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws . . . ." Pet. App. at A-7. Of the assertedly conflicting formulations, the least rigorous was estabished in *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986). *See Sanders Confectionery Prods. v. Heller Fin.*, 973 F.2d 474, 486 (6th

Cir. 1992) ("We find it unnecessary to choose between the various tests . . . because [plaintiff] failed to plead sufficient acts of control under the least rigorous standard applied in Metge."), *cert. denied*, 506 U.S. 1079 (1973). *Metge* held that the first prong required an answer to the question whether "the defendant . . . actually participated in (*i.e., exercised* control over) the operations of the corporation in general." 762 F.2d at 631 (internal quotation marks and citation omitted); *see* Pet. App. at A-6.

As can be seen, the "first prong" as formulated by the Eleventh Circuit in this case is actually *more* favorable to petitioners than the formulation employed in *Metge*: *Metge* would seem to require petitioners to prove that Respondent *actually* participated and *actually* exercised control over KCI. In contrast, the Eleventh Circuit's test focuses on the more theoretical question, whether Mendel "had the power" to control KCI. Holding aside the fact that the Eleventh Circuit seems to have adopted a standard that is closer to the statutory language, Petitioners are *not* in a position to complain to this Court that the Eleventh Circuit adopted the position most favorable to them.

6. But the existence of any "conflict" at all is illusory. Although the Eleventh Circuit used a different verbal formualtion than *Metge*, it refused to decide whether—if presented with a case that squarely required it to reject *Metge*—it would do so. It held that its standard, as it intended to apply it, was *not* necessarily inconsistent with *Metge*. While acknowledging a theoretical distinction between its test and the one in *Metge*, the Court of Appeals stated:

> The Eighth Circuit's test [*Metge*] requires a plaintiff to prove that a defendant actually exercised power over the entity primarily liable. Because we hold *infra* that Mendel *neither possessed nor exercised power over* KCI at the time the Prospectus was issued, *we do not need to decide here* whether "power to control the general affairs of the entity primarily

> liable" means simply abstract power to control or actual power to control.

Pet. App. at A-7, n.6 (emphasis added). Thus, the Court declined to create a conflict even at a theoretical level. There is no relevant conflict among the case law that could be resolved by granting this petition.

II. THE UNIQUE FACTS OF THIS CASE DO NOT WARRANT CERTIORARI

Petitioners' argument in the court below was not so much over the proper test but rather over the question whether the facts supported the grant of summary judgment under the test adopted by the district court. They reargue the facts here. But questions involving the routine application of law to facts are not proper for review on certiorari. Indeed, the unique facts of this case would limit its utility as a vehicle for addressing "controlling person" liability.

1. Mendel was not an officer, director or *even an employee* of KCI, the alleged violator, at the time of the alleged omissions; he had resigned his positions with KCI months before the allegedly omissive prospectus was drafted or disseminated.[1] Pet. App. at B-13. Although mere status as an officer or director is not enough for control liability to attach,[2] persons held liable as controlling persons of a company have generally been officers or directors of that company.[3]

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[1] Petitioners had originally alleged that Mendel was Chairman of the Board of KCI at the time of the October 1989 rights offering. Pet. App. at B-13. This contention was simply untrue. Pet. App. at A-2, B-13.

[2] *See Arthur Children's Trust v. Kiem*, 994 F.2d 1390, 1396 (9th Cir. 1993); *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981).

[3] *E.g., G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981) (officer and director); *Cameron v. Outdoor Resorts of America*, 608 F.2d 187 (5th Cir. 1979), *opinion on reh'g*, 611 F.2d 105 (5th Cir. 1980) (president); *Arthur Children's Trust*, 994 F.2d at 1397 (member of management committee); *San Francisco-*

2. It appears that Petitioners are disturbed by the fact that some time prior to the events in question, Mendel might have been more easily characterized as a "controlling person" at the time of the alleged violation of the Act. Pet. at 3. But they ultimately do not dispute that the relevant time is the time of the alleged underlying violation of the Act. The unique facts concerning the timing of events here does not warrant certiorari.

3. To try to build a case of factual error rendering the decision below "erroneous," Petitioners try various tacks. First, they blend two very different restructuring plans—one adopted before and one after Mendel's resignation—so as to create the illusion that some fraudulent scheme was undertaken by KCI while Mendel was at its helm. Petitioners do this despite the fact that—as both the Court of Appeals and the district court correctly noted—Petitioners have not claimed that the rights offering itself was fraudulent; the only allegation was that the Prospectus issued pursuant to the offering contained material omissions. Pet. App. at A-8, B-14. That was the time that was the proper focus of the analysis.

Second, they suggest that Mendel's position with KCLC made a controlling person of KCI. Mendel's *position with KCLC*, a KCI subsidiary, provides no basis to conclude that he *controlled KCI*. Indeed, KCI had power over KCLC. When the Prospectus was issued, KCI owned 87% of KCLC's outstanding stock and was KCLC's controlling shareholder. Pet. App. at A-2.

Third, Petitioners seek to build something on a statement in the Prospectus that "KCI and KCLC were commonly controlled[.]" Although Petitioners assert that this

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Oklahoma Petroleum Exploration Corp. v. Carstan Oil Co., 765 F.2d 962, 965 (10th Cir. 1985) (director and sole shareholder); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d at 891 (3rd Cir. 1975) (president, chairman of the board, and chief executive officer); *Binder v. Gordian Securities*, 742 F. Supp. 663, 668 (N.D. Ga. 1990) (vice president).

statement could mean that Mendel controlled KCI by virtue of his position with KCLC—which would be inconsistent with the facts as they actually exist—the statement is simply a reference to the fact that KCI had the power to control KCLC.

Finally, Petitioners point to Mendel's attendance at the September 14, 1989 KCI board meeting in his capacity as KCLC's chairman as evidence of Mendel's control status following his resignation. Although alternative restructuring plans were discussed at this meeting, none were approved. The final restructuring plan was adopted at a subsequent meeting, which Mendel did not attend. Pet. App. at A-2.

The Court of Appeals correctly concluded that "[t]here is no evidence in the record that Mendel had any power over KCI at the time of the issuance of the Prospectus," Pet. App. at A-7, and therefore, he is not a "controlling person" under the statute or the regulation, on their face, or under any of the applicable "tests."

CONCLUSION

The petition should be denied.

Respectfully submitted,

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